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FINANCE AND GROWTH IN SUB-SAHARAN AFRICA:

Policy and research challenges

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Abstract

This article looks at lessons from the 2007/2008 global financial crises for African low-income countries' financial sectors and suggests research questions which need to be investigated. It examines lessons from recent empirical literature both for the scale and structure of the financial sector as well as its regulation. Excessive—and too rapid growth—of the financial sector is warned against as it can cause very costly financial crises and does not necessarily contribute to financing the real economy. The paper recommends that where market failures exist, government interventions through public institutions or indirect mechanisms may be desirable.

1. INTRODUCTION

Finance provides a particularly challenging and important field for policy design and policy-relevant research, especially if placed in the context of those countries' needs for development. The policy challenges and research needs are very large, due partly to a major rethinking of the role, scale and structure of a desirable financial sector, as well as its regulation,

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in light of the major financial crisis that started in 2007/8. There is an urgent need to understand the implications of this policy and analytical rethinking for Sub-Saharan African (SSA), especially low income countries' (LICs) financial sectors, especially regarding its impact on their economic growth.

The financial sectors of African LICs are still at an early stage of development, so lessons from the crisis could inform their financial sector development strategies. Moreover, their financial sectors, while generally still shallow, are experiencing fairly rapid growth. Combined with African countries' existing vulnerabilities, such as limited regulatory capacity, this might pose risks to financial system stability. Despite the infrequent appearance of systemic banking crisis on the African continent over the past decade (see below), fast credit growth in many economies—even if at comparatively low levels—calls for caution, signaling the need for strong, as well as countercyclical, regulation of African financial systems. For policymakers and researchers this poses the challenge of applying the lessons from the crisis in developed and previously in emerging countries to African LICs, while paying careful attention to the specific features of African financial systems.

There are also more traditional policy challenges and research gaps on financial sectors in LICs, and their links to inclusive growth. To support growth, there are a range of functions that the financial sector must meet in African LICs, such as helping to mobilize sufficient savings; intermediating savings at low cost and long maturities to investors and consumers; ensuring that savings are channeled to the most efficient investment opportunities; and helping companies and individuals manage risk. There are also large deficiencies in these areas originating from specific market failures and/or gaps. For example, there is a lack of sustainable lending at relatively low spreads, including with long maturities to small and medium enterprises (SMEs), which is particularly constraining for growth in LICs.

This paper presents two key areas for a policy, as well as corresponding research agenda on finance and growth in Sub Saharan Africa building partly on lessons from the Global Financial Crisis: 1) the desirable size and structure of the financial sector and 2) new challenges for financial regulation. The discussions in these two areas is important to advance understanding on the links between the financial sector and inclusive as well as sustainable growth.

2. FINANCIAL SECTOR DEVELOPMENT AND GROWTH

Central bankers and financial regulators in African LICs have always faced major conceptual and institutional challenges in striking the right balance in their policy design to achieve the triple aims of financial stability, growth and equity.

These challenges acquired a new dimension in the light of numerous financial crises, initially in the developing world, but recently in developed countries. The latter led to a major re-evaluation of the role of the financial sector, its interactions with the real economy and the need for major reform of its regulation, especially in developed and emerging economies (see for example, Griffith-Jones, Ocampo and Stiglitz, 2010, as well as IMF, 2011 and 2012, as well as

Haldane and Madouros, 2012 on the need to simplify regulation); the latter resonates very well with LICs. Before examining the implications of this analysis for SSA countries, we will look first at how the Global Financial crisis affected SSA countries.

Interestingly, although the Global Financial Crisis originated in and strongly hit developed economies, its cost to developing SSA (in contrast to all LICs on average) in terms of foregone growth and investment as well as falling tax revenue with increasing budget deficits is quite substantial. Developing SSA[3] suffered a GDP growth slowdown to 4.0 percent in the aftermath of the crisis (2008-2010) in comparison to average growth rates of 4.7 percent between 2000 and 2007. This equals a loss in GDP growth of 0.7 percentage points (see table 1). SSA growth was much more affected by the recent slowdown in economic activity around the world—mainly driven by recession and stagnation in developed economies—than that of all low income countries on average, which have managed to grow by 0.4 percent more in the same period (2008-2010, compared to 2000-2007). Similarly, the crisis impact on tax revenue is potentially larger in SSA than in low income economies on average. While low income countries did not see a reduction in tax revenue in the aftermath of the crisis, taxes collected in SSA fell by 1.7 percent of GDP in comparison to pre-crisis levels. Concurrently, budget positions in SSA countries worsened by 1 percent of GDP on average.

Table 1: The Impact of the global financial crisis on high, middle and low income countries

Region/Country	Decline in GDP growth	Decline in investment (% of GDP)	Decline in tax revenue (% of GDP)	Rise in budget deficit (% of GDP)
High income countries	-2.7	-2.2	-1.2	-4.2
Middle income countries	-.08	3.2	0.8	n/a
Low income countries	0.4	3.3	0.8	n/a
Sub-Saharan Africa (developing)	-0.7	2.5	-1.7	-1.0

Note: All decline figures are calculated a difference between the 2000-07 average and the 2008-10 average. Developing Sub-Saharan Africa refers to all Sub-Saharan countries with the exception of Equatorial Guinea, which is classified as high income

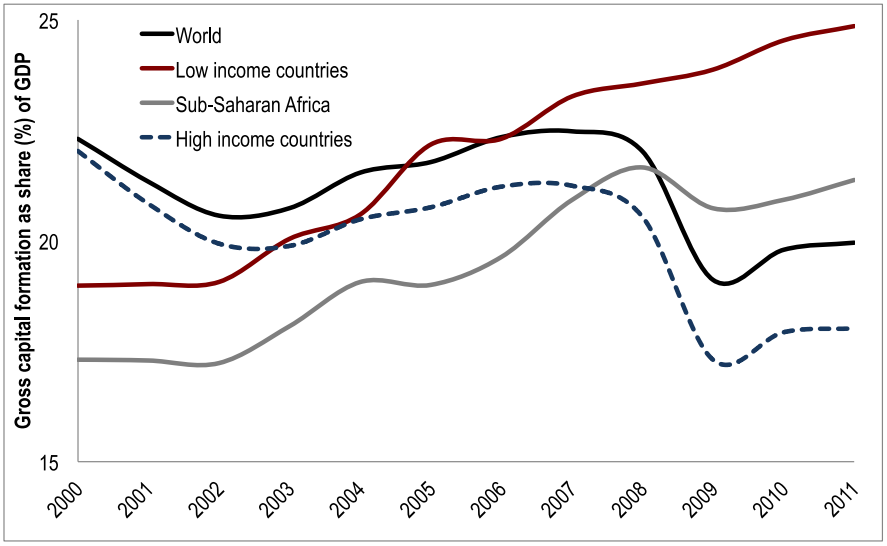
Source: World DataBank, World Bank, 2013.

Furthermore, the question can be raised whether SSA growth in investment rates would

[3] Developing SSA refers to all SAA countries with the exception of Equatorial Guinea, which is classified as high income country by the World Bank. All SSA figures in the document exclude Equatorial Guinea since the focus is on developing economies.

not have been faster in the absence of the Global Financial Crisis. Figure 1 illustrates this point. Gross capital formation (investment), as share of GDP, peaked at 22 percent in 2008 falling by almost 1.5 percentage points in the following year. The 2008 level has not been recovered as of 2011, the latest year for which data are available.

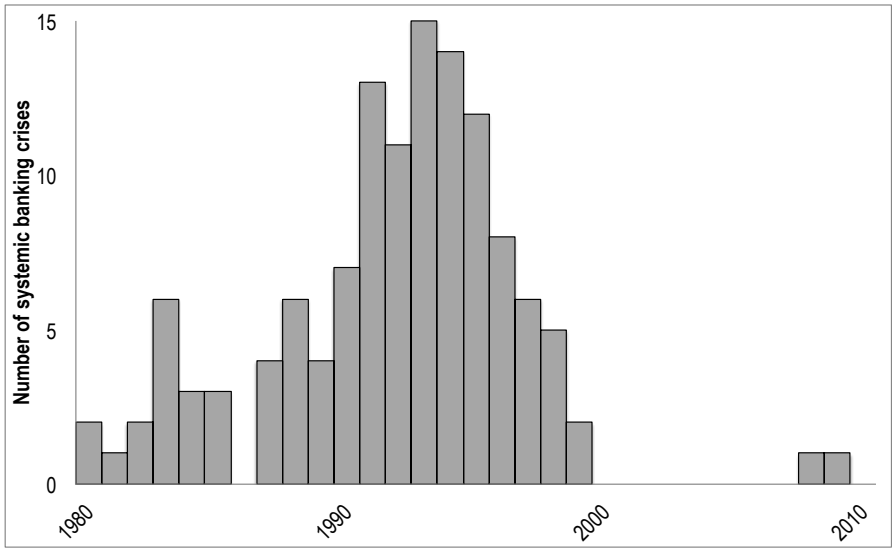
Figure 1. Impact of the global financial crisis on gross capital formation.



Source: World DataBank, World Bank, 2013.

It is interesting that the number of banking crises on the African continent has overall been remarkably low over the past decade (2000-2009), potentially indicating increased resilience of African financial systems particularly in comparison to the 1990s (see figure 2).

Figure 2. Systemic banking crises in Africa, 1980-2009



Source: Laeven and Valencia, 2008.

This argument is in line with the observation that the dissemination of the financial crisis from strongly affected advanced economies to African low income countries has mainly happened through the trade channel, falling commodity prices as well as shrinking remittances and official development assistance budgets.

In this context the Nigerian banking crisis—discussed below—is seen by some as a 'sporadic outlier' (Beck *et al*. 2011, p. 3). There is nevertheless the danger that lack of recent crises can lead to policymakers' and regulators' complacency (as well as that by the financial actors), which precisely could increase the risk of future crises. This phenomenon, known in the literature as "disaster myopia", has in the past contributed to increased risk of crises in other regions.

There has been far relatively little research and policy analysis on the implications of the Global Financial Crisis for African countries and LICs more generally, with some valuable exceptions (see for example, Kasekende *et al* 2011, and Murinde *et al*, 2012 for good analysis of regulatory issues in LICs). As African financial sectors are growing quite quickly, they may be more vulnerable to threats to their financial stability. The value added of policy analysis and research on finance and development that explores the right lessons to learn from the Global Crisis—and previous ones in emerging economies—for African LICs, is thus likely to be high. This research might help answer the question of how the need to ensure financial stability interacts with the need of a financial system in LICs that assures enough access to sustainable finance for the different sectors of the economy, including long-term finance to fund structural change, as well as different segments, such as small and medium-sized enterprises (SMEs) and infrastructure.

3. AREAS OF ANALYSIS

There are two areas of enquiry for understanding the links between the financial sector and inclusive, as well as sustainable, growth: 1) what is the desirable size and structure of the financial sector in LICs? and 2) what are the regulatory challenges to maximize the likelihood of achieving financial stability, whilst safeguarding inclusive and more sustainable growth? Political economy might be a fruitful lens through which to perform such analysis because it sheds light on the political determinants of financial policy.

3.1 SIZE AND STRUCTURE OF THE FINANCIAL SECTOR

At a broad level, what is the desirable ("optimal") size and structure of the financial sector in African countries, to maximize its ability to support the real economy? What are the desirable paths of development of the financial sector in Africa to help it maximize its contribution to growth, considering features of African countries and lessons from recent crises?

The traditional positive link between deeper as well as larger financial sector and long-term growth, that started in the literature with Bagehot and Schumpeter, but then was reflected in quite a large part of the empirical literature, such as Levine (2005), is being increasingly challenged. Authors like Easterly, Islam and Stiglitz (2000) had already early on suggested that financial depth (measured by private credit to GDP ratio) reduces volatility of output up to a point, but beyond that, actually increases output volatility. More recently, a number of papers are showing inverse relation between size of financial sector and growth, especially beyond a certain level of financial development, which is estimated at around 80-100 percent of private credit to GDP. Thus, Bank for International Settlements (BIS) economists (Cecchetti and K. Kharroubi, 2012) based on empirical work reach the following conclusions, which challenges much of earlier writing:

> "First, with finance you can have too much of a good thing. That is, at low levels, a larger financial system goes hand in hand with higher productivity growth. But there comes a point, where more banking and more credit lower growth. Secondly, looking at the impact of growth in the financial system—measured in employment or value added—on real growth, they find clear evidence that faster growth in finance is bad for aggregate real growth. This implies financial booms are bad for trend growth. Hence, macro prudential or counter-cyclical regulation, discussed below, is important."

Finally, in their examination of industry-level data, they find that industries competing for resources with finance are particularly damaged by financial booms. Specifically, manufacturing sectors that are R&D-intensive suffer disproportionate reductions in productivity growth when finance increases.

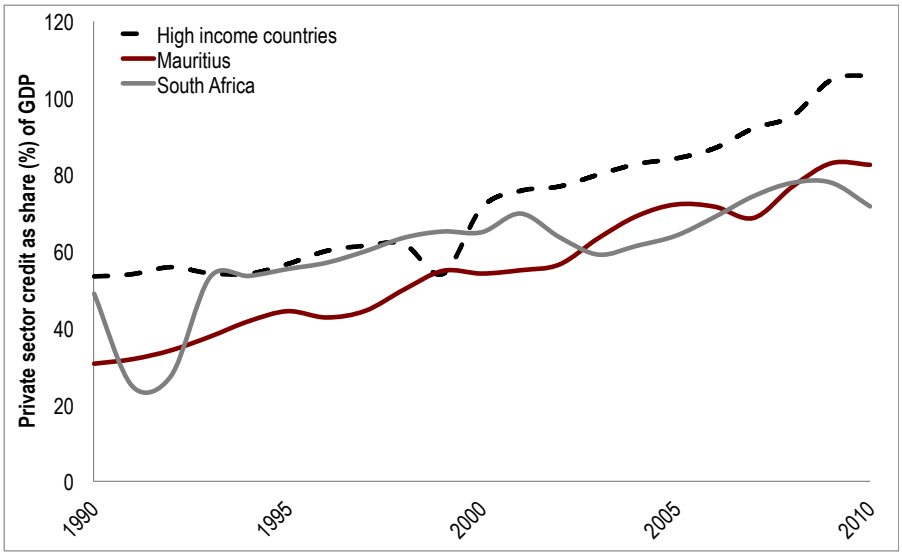
Similarly, an IMF Discussion Paper (IMF, 2012a) suggests empirical explanations for the fact that large financial sectors may have negative effects on economic growth. It gives two

possible reasons. The first has to do with increased probability of large economic crashes (Minsky, 1974, Kindleberger, 1978 and Rajan, 2005) and the second relates to potential misallocation of resources, even in good times (Tobin, 1984). De la Torre *et al*, 2011, point out that "Too much finance" may be consistent with positive but decreasing returns of financial depth which, at some point, become smaller than the cost of instability. It is interesting that the IMF Discussion paper, (*op cit*.) results are robust to restricting the analysis to tranquil periods. This suggests that volatility and banking crises are only part of the story. The explanation for the "Too Much Finance" result is not only due to financial crises and volatility, but also misallocation of resources.

It is also plausible that the relationship between financial depth and economic growth depends, at least in part, on whether lending is used to finance investment in productive assets or to feed speculative bubbles. Not only where credit serves to feed speculative bubbles—where excessive increases can actually be negative for growth—but also where it is used for consumption purposes as opposed to productive investment, the effect of financial depth on economic growth seems limited. Using data for 45 countries for the period 1994-2005, Beck *et al*. (2012), and Beck *et al*., (2011) show that enterprise credit is positively associated with economic growth but that there is no correlation between growth and household credit. Given that the share of bank lending to households increases with economic and financial development and household credit is often used for consumption purposes whereas enterprise credit is used for productive investment, the allocation of resources goes some way towards explaining the non-linear finance-growth relationship. In African countries, only a small share of bank lending goes to households. However, as financial sectors and economies grow, this will change, as has been the case in South Africa.

Rapidly growing credit to households—even though desirable when strengthening reasonable levels of domestic demand and financial inclusion, in a sustainable way—might, however, cause financial instability if not regulated prudently. This is especially the case if lending is excessively channeled into the construction sector, creating a housing bubble. The two most advanced African economies, South Africa and Mauritius—both upper middle income countries—have recently experienced or are currently experiencing a construction boom. Both economies possess relatively deep financial markets with strong private domestic lending including significant consumption credit extension. Figure 3 shows that private credit in high income economies was around 100 percent of GDP on average in 2010 while it accounted for 70-80 percent of GDP in Mauritius and South Africa.

Figure 3. Private credit extension in African middle income countries compared to high income countries, 1990-2000

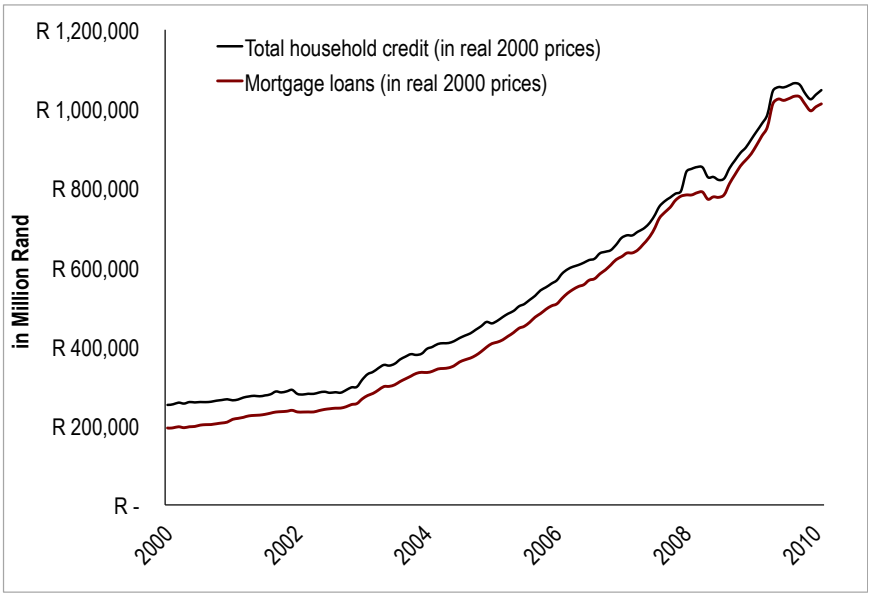


Source: World Development Indicators, World DataBank, World Bank, 2013.

In international comparison, South Africa was the country in Africa which experiences the strongest house real price gains between 2004 and 2007, by far exceeding even the price growth in the booming residential property markets of the US and the UK (see figure 4). In South Africa the ratio of household to business credit is approximately 1:1. The large majority of household borrowing takes on the form of mortgage finance. During the early 2000s this led to an unprecedented housing boom in South Africa fed by growth in housing loans of over 500 percent in real terms between 2000 and 2010 (see figure 5). This was largely absorbed by upper income South African households accounting for three quarters of total household credit created (DTI, 2010). In an attempt to reduce inflation, asset price increases and potential macro-economic over-heating, the South African Reserve Bank gradually initiated monetary tightening in June 2006, accelerating the rise in interest rates the following year.

The subsequent economic slowdown in South Africa was to a large extent based on domestically accumulating economic and financial imbalances while the Global Financial Crisis merely intensified the recession of 2008/09. The fact that credit and consumption-led growth was unsustainable in South Africa was illustrated in over 1 million jobs shed in 2008/09, largely in low-skilled consumption-driven sectors. A positive aspect was that there was no financial crisis, perhaps because of the positive policy response from the economic authorities; however, as mortgage credit picks up, and especially if it does at a very fast pace, care has to be taken to regulate this. The South African experience reiterates that private sector credit expansion at very high levels might lead to output volatility and adverse growth effects (see Easterly, Islam and Stiglitz, *op cit*, and Cecchetti and K. Kharroubi, *op cit*). In order to prevent future crisis and foster economic development a re-orientation towards more business credit, particularly for productive investment, might be needed.

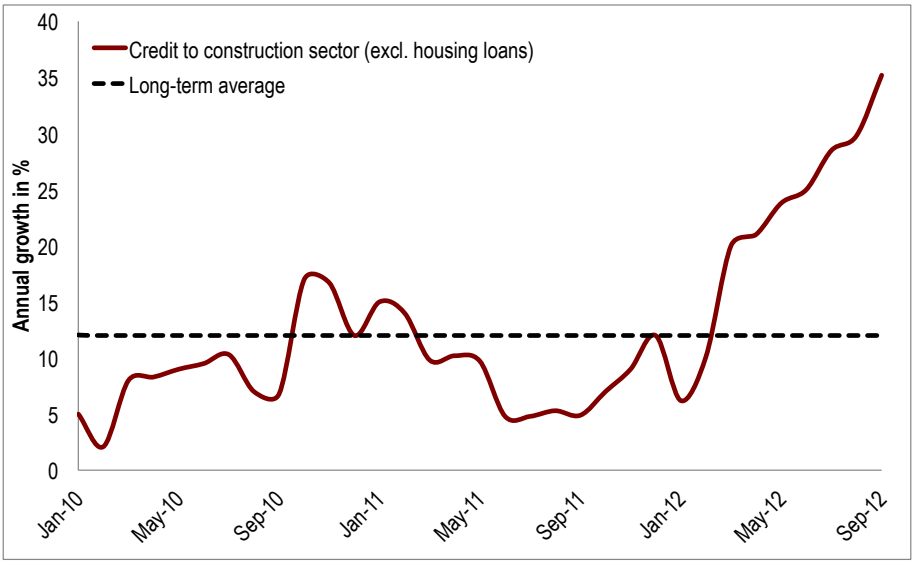
Figure 5. South African private sector credit extension by purpose, 1990-2012



Source: SARB, 2013.

In Mauritius almost one third of private sector credit flows to households, equaling 20 percent of GDP by late 2012. The majority of household borrowing is mortgage finance (60 percent of total household credit) with the rest used to fund consumption (40 percent). Given sustained demand for residential property housing credit has been growing close to 20 percent annually on average over the past 5 years (Bank of Mauritius, 2012). Simultaneously, foreign direct investment (FDI) flows into the country concentrate on real estate activities with the bulk in tourist resorts, real estate and invest hotels schemes. The construction industry accounted for approximately half of FDI inflows in recent years (2008-2012). Mauritius's construction boom should be monitored with caution, which has also been pointed out by the IMF Article IV Mission Consultation. Financial vulnerabilities appear to be accumulating in the industry with potential adverse impact on balance sheets of domestic commercial banks. Even though non-performing loans as share of total credit are at reasonably low levels, they have increased from 2.1 percent to 3.1 percent between 2010 and 2012. Furthermore, non-performing loans in the construction industry (excluding housing loans) as share of sectorial credit are more than twice as high, rising from around 5 percent in 2010 to 8 percent last year. This development is worrying and calls for counter-cyclical regulation especially since year-on-year growth in construction credit has shot up sharply during 2012, exceeding 35 percent by September. This is almost three times above the long-term average (see figure 6).

Figure 6. Construction sector credit in Mauritius

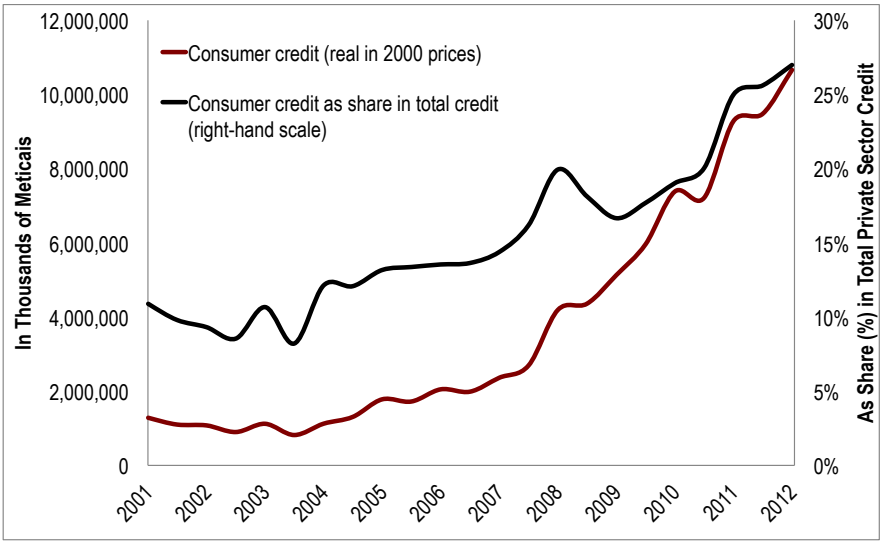


Source: Bank of Mauritius, 2012.

Limited data availability makes it difficult to measure to what extent consumption credit is on the rise in other African economies. This would seem to make the case for more disaggregated credit data, as well as monitoring by regulators as well as policymakers, more urgent.

One of the few low income SSA countries providing disaggregated domestic lending data is Mozambique (Banco de Moçambique, 2013). Private sector credit has increased significantly between 2000 and 2010 in the Southern African country from 15 percent to 23 percent of GDP (see table 2 below). During this period consumer borrowing almost tripled as share of total credit while it grew almost eightfold between 2001 and 2012 in real terms (see figure 7). Mozambique has had a strong growth performance implying a robust medium-term economic outlook despite stagnant poverty reduction and the need for more inclusive growth (IMF, 2012).

Figure 7. Mozambican consumer credit in real terms and as share of total private sector credit, 2001-2012



Source: Banco de Moçambique, 2013

Nevertheless, falling consumer price inflation has been accompanied by potential price pressures present in urban housing markets, which are difficult to assess due to lack of house price data for Mozambique. Significant housing rent increases (20-25 percent per year) have been reported for upmarket and expatriate areas of Maputo (Emerging Markets Consultants, 2012) while central areas in Mozambican towns and cities (so-called 'cement cities') have been observed to experience property price growth of 100 percent annually (CAHF, 2012).

More broadly, as we began to discuss above, of relevance for growth is thus the link between the structure of the financial sector and growth. The IMF in its Global Financial Stability Report (IMF, 2012b) has interesting further empirical analysis of the relationship between the structure of the financial sector and economic growth, as well as the volatility of this growth and financial stress. This is a fairly under-studied area, and one which has hardly been applied to LICs. The preliminary empirical results of the IMF report suggest that cross-border connections through foreign banks may during crises be associated with instability, though their role may be more beneficial in normal times. The empirical evidence also seems to show that "a domestic financial system that is dominated by some types of non-traditional bank intermediation has in some cases been associated with adverse economic outcomes, especially during financial crises."

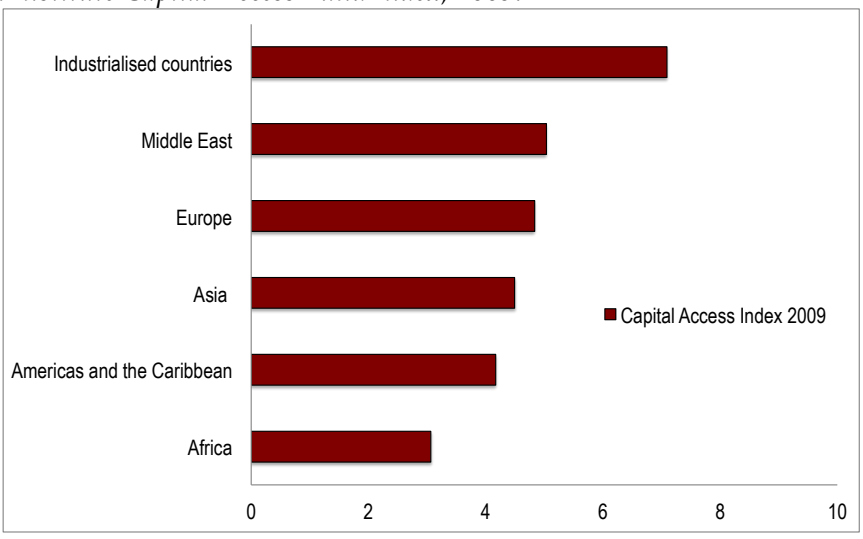
Crucial in the context of policymaking and research on finance in Africa is the extent to which the findings on the relationship between the structure and size of the financial sector and growth in more developed economies are relevant for and apply to African LICs because their financial systems are markedly different. In particular, these countries' banking systems are small in absolute and relative size, many of them reaching the size of mid-sized banks in high-income countries. Beck *et al*. (2011), *op cit* report for instance, that if measured in relative size

based on the claims on the private domestic nonfinancial sector to GDP (private credit), the median for African countries as a whole (i.e. including North African countries) was 19 percent in 2009, while it was 49 percent for non-African developing countries. African financial sectors also show levels of financial intermediation and access to financial services has remained limited for large segments like SMEs, the agricultural sector or poor households. Many of those use informal financial services. In addition, African financial systems are mainly bank-based with non-bank segments showing an even lower level of development.

Given the importance of SMEs in creating employment, the lack of financial infrastructure supporting their activity in African financial systems is a major drawback for development. International financial indicators show that African businesses in general are disadvantaged through less access to finance than competitors in other regions. Concurrently, SMEs enjoy a particularly poor access to sources of finance, leaving them with internal cash flow as main source for investment finance. As consequence, enabling African SMEs to better access financing sources has the potential to strengthen and accelerate growth if done on sustainable grounds under adequate regulation.

The obstacles African SMEs experience in their domestic financial systems are mainly concentrated around the insufficient support by financial and banking institutions, lacking development of equity and bond markets and alternative sources of finance. Therefore, recent developments of deepening African financial markets might help SME growth if successfully and sustainably channeled into this segment. International indicators such as the capital access index and domestic analysis via enterprise surveys, by company size, support this view as argued below.

Figure 8. Milken Institute Capital Access Fund Index, 2009.



Source: Milken Institute, 2010.

A measure that can be used to understand the overall ability of businesses and entrepreneurs to access domestic and foreign capital is the Milken Institute's capital access index, CAI (Barth *et al*., 2010) which is a ranking tool of the relative strength and performance of

capital markets around the world[4]. African economies perform most poorly, with a score of 3.07 on a scale of 0 to 10, on business access to capital (see figure 8). Furthermore, of the 61 countries that form the bottom half of the ranking, 30 are African countries, while 17 of the 20 countries with the lowest scores are African low income economies (see table 2).

Table 2: Bottom 20 CAI scores and country rankings

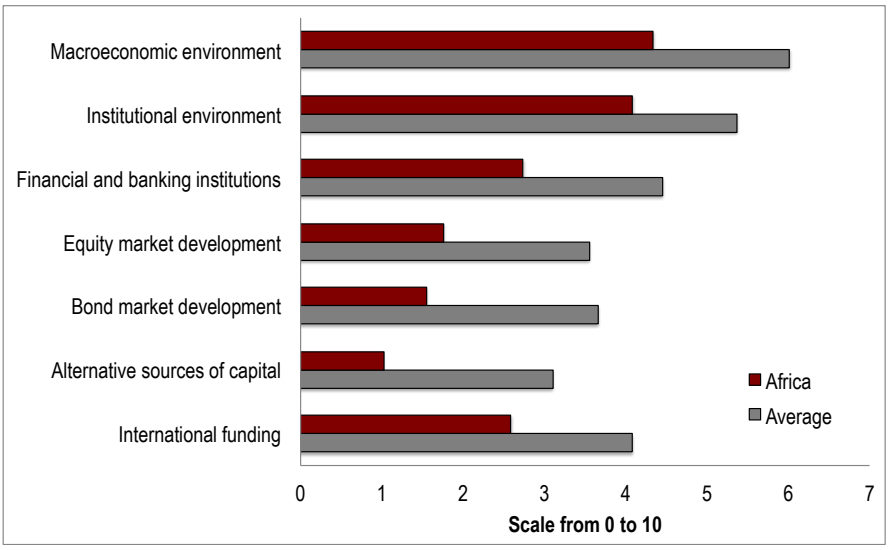
Country	**Score**
Mozambique	2.74
Cameroon	2.67
Rwanda	2.64
Burkina Faso	2.63
Syria	2.59
Benin	2.58
Sierra Leone	2.56
Ethiopia	2.44
Laos	2.37
Mali	2.37
Central Africa Republic	2.32
Togo	2.31
Guinea	2.19
Mauritania	2.18
Republic of Congo	2.17
Madagascar	2.13
Chad	2.06
Niger	2.03
Haiti	1.95
Burundi	1.87

Source: Milken Institute, 2010.

The graphs below illustrates the difficulties that African businesses and entrepreneurs have in accessing finance (see figure 10), in comparison to the average for all countries in more detail (see figure 9). African economies struggle to establish internationally competitive financial and banking institutions, to support equity and bond market development as well as to develop alternative sources of finance. All these, and particularly alternative sources of finance, could serve as crucial sources of finance for SMEs.

[4] This is achieved by assessing the macroeconomic environment, institutional environment, financial and banking institutions, equity market development, bond market development, alternative sources of capital, international funding in the relevant countries. The CAI is compiled by the Milken Institute and ranks 122 nations on six continents. The latest CAI, referred to in this document, has been provided by the Milken Institute for 2009.

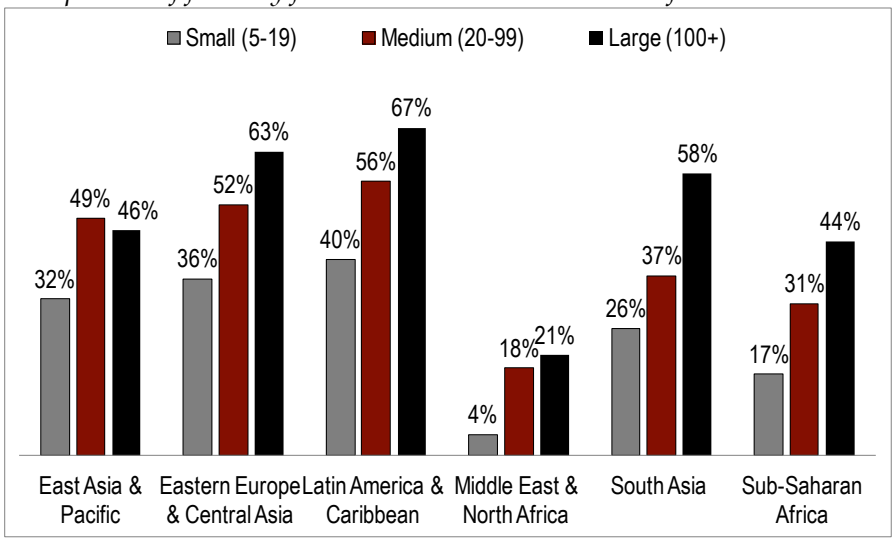
Figure 9. CAI components for Africa compared to the average.



Source: World Bank, 2013.

There is a gap of 4.28 (ranked out of 10) in the score between the top (South Africa) and the worst performing African country (Burundi) in the CAI ranking. This could indicate large discrepancy in financial sector development on the African continent.

Figure 10: Regional percent of firms by firm size with a bank loan/line of credit



Source: World Bank, 2013.
Note: Years vary for different regions, ranging from between 2006—2012.

Assessing the ability of firms to access finance more deeply, the percentage of small, medium and large firms that have a bank loan or a credit line can serve as a measure (see figures 10 and 11). Sub-Saharan African small and medium sized firms have poor access to finance (only 17 percent of them, as opposed to 40 percent in Latin America, and 32 percent in

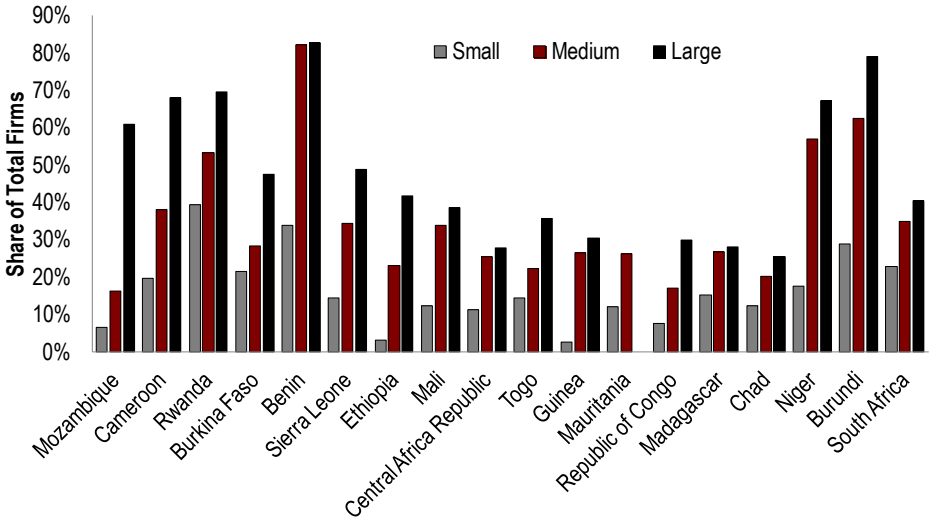
East Asia) when compared to other developing regions, performing only better than Middle East and North Africa region. This analysis of access to credit by firm size is taken further below for some Sub-Saharan African countries on two levels:

1) By looking at the firms of different sizes and the implications on the ability of the firm to have a bank loan or a credit line;

2) By assessing whether the performance based on the size of the firm is different if the CAI score for the African country was in the bottom half or the top half.

In some cases where the CAI score is high small businesses have nevertheless poorer access to finance (measured as share of total firms with access to bank loan/line of credit) than countries that scored in the bottom of the CAI rankings. This is true, for example, for South Africa as compared to Rwanda, Burundi and Benin (see figure 11).

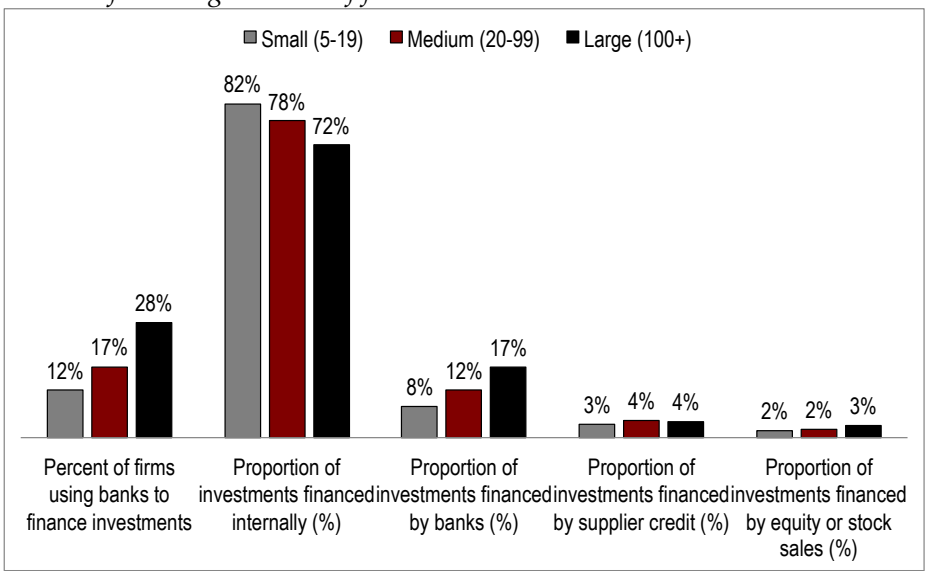
Figure 11. Access to bank loans and/or lines of credit by some SSA countries' firms.



Source: World Bank, 2013.
Note: Years vary for different countries, ranging from between 2006—2011.

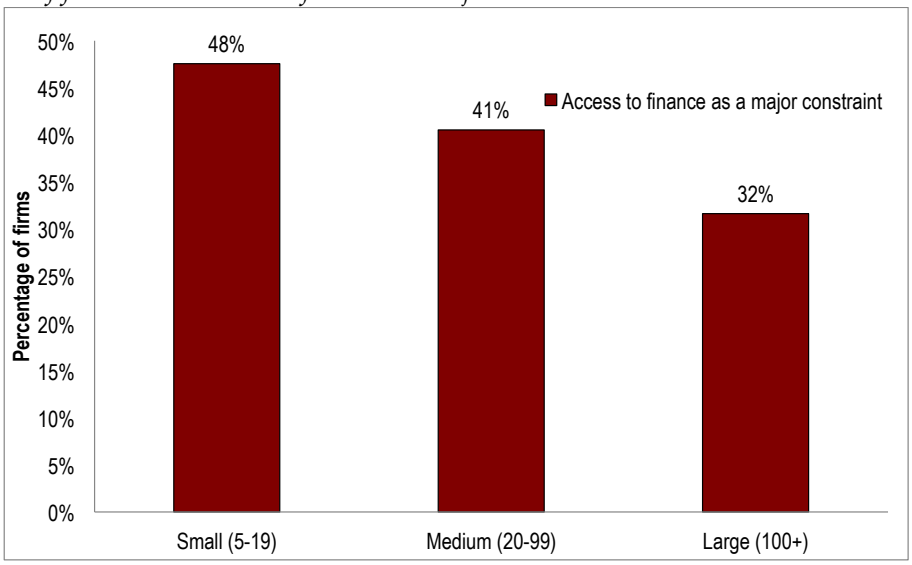
In general, between 60 percent and 70 percent of SMEs in Sub-Saharan Africa need loans, however only 17 percent of small and 31 percent of medium-sized firms actually have access to finance. As a consequence, firms in Sub-Saharan Africa have to finance a high proportion of investment through internally generated cash flows (82 percent among small Sub-Saharan African firms, see figure 12). This reflects the CAI finding that African countries lack developed equity and bond markets, alternative sources of capital and that there are low levels of lending by banking institutions. Not surprisingly, approximately 50 percent of small enterprises in Sub-Saharan Africa have identified access to finance as a major obstacle to their business activities (see figure 13).

Figure 12. Investment financing methods of firms in SSA.



Source: World Bank, 2013.

Figure 13. Share of firms with access to finance as major constraint.



Source: World Bank, 2013.

In an effort to increase the level of participation of financial institutions to finance small medium enterprises public banks, such as the African Development Bank (AfDB), are driving a number of initiatives designed to encourage the participation of financial institutions. One notable initiative is the African Guarantee Fund (AGF), which is a for-profit social investment fund. The AGF is owned by AfDB, AECID and DANIDA with contributions of US$10 million,

US$20 million and US$20 million, respectively (African Development Bank, 2012). Over the next 3 to 5 years, this share capital is expected to increase to US$500 million, giving the institution capacity to guarantee up to US$2 billion worth of SME loans. The additional capital will be coming from bilateral donors, private investors as well as from DFIs (African Development Bank, 2012). The AGF will select certain financial institutions to be partner institutions by assessing their commitment to grow their SME portfolio and improving financial product offerings to SMEs. For these partner institutions AGF will have two lines of activity:

1) Partial credit guarantees: the provision of partial guarantees for financial institutions on the African continent to incentivize them to increase debt and equity investments into SMEs. These guarantees, with different fee structures (see table 3), will support:

    a) Loans made by client financial institutions to SMEs through a hybrid approach (portfolio and individual loan basis);

    b) Funds mobilization (i.e. issuance of bonds) by financial institutions in support of their SME financing activities; and

    c) Equity capital financing for SMEs.

2) Capacity development: supporting AGFs partner institutions enhance their SME financing capabilities through assisting to improve the capacity to appraise and manage SME portfolios (African Development Bank, 2013).

Table 3. Mechanisms of the AGF

Guarantee type	Guarantee Limit	Pricing	
		Originating Fee (flat)	Guarantee Commissions (p.a.)
Portfolio (Loan) guarantee	US$2,500,000	0.75%	2.00%
Individual (Loan) Guarantee	US$500,000	0.75%	1.75%
Equity Capital Guarantee	US$500,000	1.00%	5.00%
Resource Mobilization Guarantee	US$1,000,000	1.00%	2.50%

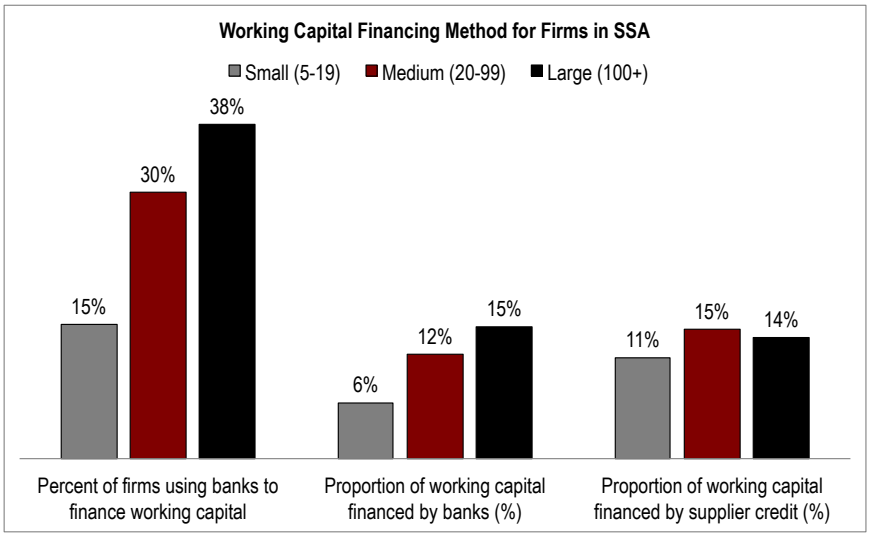
Source: African Guarantee Fund, 2013.

Operationally, the AGF will work on a risk-sharing basis with financial institutions and the maximum risk coverage ratio will be 50 percent. The balance of risk will be borne by the financial institutions (African Development Bank, 2013). AGF is designed to achieve a triple-A rating in order to attract a zero percent risk-weight on SME loans provided by partner institutions. This will allow these institutions to lend money with limited need to set aside regulatory capital because of the guarantee from the highly-rated AGF. The tenor of the guarantee will be for 80 percent of the life of the underlying transaction. The first of the AGF

guarantee agreements are expected to be signed imminently and thus an assessment of the guarantee is not possible at this point, however, it is reported that there is high interest from financial institutions on the African continent (African Development Bank, 2012).

It is worth noting for the purposes of future research that over and above the general consensus that SMEs lack long-term finance at reasonable lending rates, working capital facilities are also starting to be emphasized. The AfDB notes that (African Development Bank, 2012, p. 3): "SMEs … complain … how banks are hesitant to provide long-term lending and working capital facilities, both of which they need for growth." Currently, 15 percent of small enterprises in Sub-Saharan Africa use banks to finance working capital, however, only a small proportion (6 percent) of their working capital needs are covered by this type of finance (see figure 14).

Figure 14. Financing of working capital by SSA firms.



Source: World Bank, 2013.

The need for working capital finance from financial institutions is echoed by Standard Bank, which found that there is a need for working capital facilities for SMEs in Sub-Saharan Africa (Botha, 2011). To this end, Standard Bank has launched a product called Quick Loans, which provides unsecured loans of between US$300 to US$30000 for 3 to 12 months, as well as other forms of finance to traders (Standard Bank, 2013). Standard Bank (2013) has established SME banking in 13 African Countries (excluding South Africa) and during 2011 provided financial services to more than 150,000 SMEs across these countries.

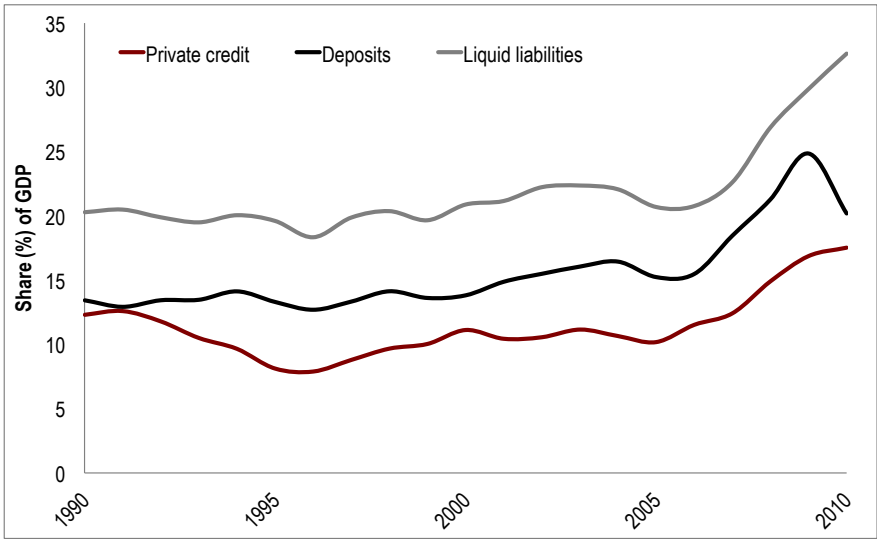
In general data on the asset composition of banks across different regions shows that unlike banks in other regions of the world, African banks hold a much smaller share of their assets in private sector loans and a much larger share in government securities, foreign assets, and liquid assets (Beck *et al*., 2011, op cit). Household credit constitutes only a small share in bank credit, except in countries where financial sectors are more developed like South Africa.

Banking sectors in most African countries are highly concentrated. In many countries, banks are predominantly foreign-owned, many of them being regional banks from other

African countries. Banks also operate very profitably, with subsidiaries of foreign banks in sub-Saharan Africa having higher returns on assets than subsidiaries of the same banks in other regions (Honohan and Beck, 2007).

It is not clear the extent to which the findings on the reverse link between financial depth and growth found in the context of developed and emerging economies is as relevant for low income countries, with a much lower level of financial development, and with large parts of the population and companies, lacking any access to financial services, as to countries with far deeper financial sectors. However, these findings will certainly be relevant for designing policies that will influence their future evolution. Furthermore, it may well be that in the near-term, the issue is more related to avoiding excessive speed of growth of finance, that we have started to illustrate above, which may be more the threat to financial stability in the case of Sub-Saharan Africa, (SSA). Indeed, as shown in figure 15, financial deepening in SSA has accelerated in recent years. The amount of private credit as share of GDP almost doubled from an average of 10 percent during the 1990s to 18 percent by 2010. Bank deposits as share of GDP grew from 13 percent (in 1990-1999) to more than 20 percent (in 2010), while liquid liabilities (also known as broad money or M3)[5] to GDP rose by more than 10 percentage points over the same period from 20 percent to exceed 30 percent.

Figure 15. Financial deepening in Sub-Saharan Africa, 1990-2010.



Source: Global Financial Development Database, the World Bank, 2012.
Note: Sub-Saharan Africa regional aggregate. This Figure was prepared by Florence Dafe.

[5] They are the sum of currency and deposits in the central bank (M0), plus transferable deposits and electronic currency (M1), plus time and savings deposits, foreign currency transferable deposits, certificates of deposit, and securities repurchase agreements (M2), plus travellers checks, foreign currency time deposits, commercial paper, and shares of mutual funds or market funds held by residents. This definition of broad money is used by the IMF and the World Bank.

The above aggregate figures do not do justice to the fast pace of credit expansion in certain SSA economies. Table 4 provides country data about credit extension as share of GDP for all SSA economies individually. It highlights countries which have experienced a doubling of private credit to GDP within the past decade (2000-2010) in light gray. Economies where private credit tripled or increased up to tenfold over the same period are given in dark gray whereas SSA states that saw a rise in lending to the private sector of ten times or more are highlighted in black.

Table 4. Credit Extension in Sub-Saharan Africa by Country, 1990, 2000, 2010.

Country	1990	20000	2010	Credit growth 2000-2010 (%)
Sub-Saharan Africa (developing)	9.2%	11.0%	17.5%	59.1%
Angola	n/a	1.1%	18.1%	1545.5%
Benin	n/a	11.1%	22.1%	99.1%
Botswana	7.8%	13.9%	22.3%	60.4%
Burkina Faso	16.2%	10.8%	16.5%	52.8%
Burundi	7.4%	17.3%	20.0%	15.6%
Cameroon	27.1%	7.7%	11.1%	44.2%
Cape Verde	4.0%	37.5%	59.2%	57.9%
Central African Republic	7.4%	4.4%	7.4%	68.2%
Chad*	6.5%	3.4%	5.0%	47.1%
Comoros*	n/a	8.3%	12.2%	47.0%
Congo, Dem. Rep.	n/a	n/a	n/a	n/a
Congo, Rep.	n/a	5.7%	4.1%	-28.1%
Côte d'Ivoire	36.4%	15.2%	17.3%	13.8%
Eritrea	n/a	n/a	n/a	n/a
Ethiopia*	1.6%	18.2%	17.2%	-5.5%
Gabon	n/a	8.3%	8.1%	-2.4%
Gambia, The	10.0%	11.6%	17.7%	52.6%
Ghana	5.0%	11.7%	13.7%	17.1%
Guinea	n/a	n/a	n/a	n/a
Guinea-Bissau*	13.0%	7.6%	5.8%	-23.7%
Kenya	17.7%	25.6%	30.6%	19.5%
Lesotho	13.8%	14.0%	12.6%	-10.0%
Liberia*	n/a	n/a	13.8%	n/a
Madagascar	14.5%	8.0%	11.1%	38.8%
Malawi	9.2%	4.5%	14.2%	215.6%
Mali	9.2%	4.5%	17.4%	286.7%
Mauritania	31.1%	n/a	n/a	n/a
Mauritius	30.1%	54.2%	82.3%	51.8%
Mozambique	n/a	15.4%	23.2%	50.6%
Namibia	n/a	39.1%	43.7%	11.8%
Niger	12.8%	4.3%	11.8%	174.4%
Nigeria	8.8%	11.1%	30.3%	173.0%

Country	1990	20000	2010	Credit growth 2000-2010 (%)
Rwanda	7.4%	9.5%	n/a	n/a
Sao Tome and Principe*	n/a	4.1%	33.2%	709.8%
Senegal	27.5%	16.5%	24.5%	48.5%
Seychelles	7.0%	15.2%	22.9%	50.7%
Sierra Leone	3.3%	1.9%	9.2%	384.2%
Somalia	n/a	n/a	n/a	n/a
South Africa	49.1%	65.0%	71.7%	10.3%
South Sudan	n/a	n/a	n/a	n/a
Sudan	4.3%	1.8%	10.9%	505.6%
Swaziland	14.2%	12.6%	23.1%	83.3%
Tanzania	12.4%	3.9%	14.6%	274.4%
Togo	22.7%	15.7%	20.7%	31.8%
Uganda	2.5%	5.3%	13.4%	152.8%
Zambia	6.8%	6.7%	10.7%	59.7%
Zimbabwe	0.0%	0.8%	n/a	n/a

Source: Global Financial Development Database and World Development Indicators, World DataBank, World Bank.

* Where 1990 or 2010 data were unavailable 1991 or 2009 data were used if possible .

Countries where private credit extension has (almost) doubled between 2000 and 2010 are highlighted in yellow.

Countries where private credit extension has increased threefold or more (but less than tenfold) are highlighted in orange.

Countries where private credit extension has increased tenfold or more are highlighted in red.

This analysis shows that in the recent decade there has been a considerable number of SSA countries with very rapid credit growth, namely:

- Benin and Swaziland where credit to GDP (almost) doubled;
- Malawi, Mali, Niger, Nigeria, São Tomé and Príncipe, Sierra Leone, Sudan, Tanzania and Uganda where credit to GDP increased threefold and more (but less than tenfold);
- Angola with private credit growing by a factor of more than 15-fold, or 1500 percent.

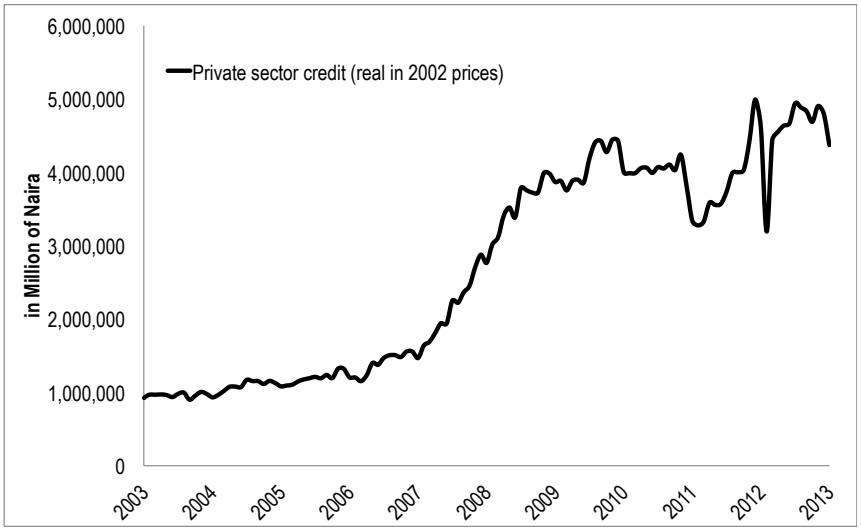
Though this is a rough indicator, countries in the last two categories would seem more vulnerable to potential crises, so they may need to examine whether they need to introduce tighter regulations, in general, or in particular sectors.

Financial systems in many African countries share features which seem to increase their vulnerability to shocks in the economic and financial system, including limited financial regulatory capacity, macroeconomic volatility linked to the economic structure of the countries (e.g. natural resource dependence, which implies volatility of their terms of trade) and political pressure for financial deepening with a view to develop the real economy.

Fast credit growth might exacerbate vulnerabilities and enhance the risk of financial crises, as it has done in all other regions of the world. In the African context, the case of Nigeria provides a recent illustration that banking crises might cause a negative link between financial deepening and growth, even at relatively low levels of financial development. In 2004/2005 the Central Bank of Nigeria (CBN) mandated a steep increase of minimum bank capitalization with a view to create large internationally competitive banks and increase financial depth (Soludo,

2004). Banks achieved this capitalization, which was high even by international standards, by means of equity investment, mergers and acquisitions, resulting in the consolidation of the banking sector from 89 to 25 banks. The consolidation in the domestic banking sector, along with abundant capital in the wake of rising oil prices increased the speed of credit creation with significant flows to sectors with little growth impact. Between 2006 and 2009 private credit tripled from 12 percent to 36 percent of GDP. In real terms (2002 prices) this meant that domestic borrowing by the private sector grew almost fivefold (see figure 16).

Figure 16. Nigerian private sector credit extension, 2003-2013.



Source: Central Bank of Nigeria, 2013

This included loans used to finance share purchases, an undesirable practice clearly, setting the stage for a financial asset bubble particularly in bank stocks (Sanusi, 2010). The financial sector boom ended in a bust with a systemic banking crisis in 2009 as financial sector growth was excessive, partly because it had not been accompanied by the corresponding regulatory and supervisory upgrade. Consequently, non-performing loans as percentage of gross loans rose sharply from 9.5 percent in 2007 to almost 30 percent in 2009. Finally, nine financial institutions that were close to collapse had to be rescued at the cost of US$4 billion. The cost of cleaning up the balance sheets and recapitalizing the banks concerned is estimated at about 2.4 trillion Naira, equivalent to almost 8 percent of GDP (IMF, 2011). The Nigerian crisis shows there is no reason for complacency about the need for rigorous financial regulation in African economies especially in the face of rapid credit expansion in many SSA markets.

With respect to the effect of foreign bank presence on financial stability and growth in Africa, the existing evidence is somewhat ambiguous and requires further research. There are indications that foreign banks can bring in experience from other regional economies and can help exploit scale economies in small host countries. Yet the benefits for financial access remain ambiguous, partly because of the greater reliance of foreign banks on "hard" information about borrowers as opposed to soft information which often implies a focus on prime borrowers

(Detragiache *et al*., 2008, Sengupta, 2007). Furthermore, it seems that foreign banks are fundamentally different from domestic banks. As argued by Rashid (2011) foreign banks seem less inclined to lending and their loans are likely to be more volatile than those offered by domestic banks. Despite strong foreign bank presence, the effects of the global financial crisis on African banks have been limited. In part, this is due to the relatively limited presence of banks from developed economies in Africa (with a high proportion of foreign banks being regional ones) and the fact that existing subsidiaries mostly fund themselves locally and not via their parents; this, however, limits the contribution these foreign banks make to national savings (Fuchs *et al*, 2011). In addition, reportedly large capital buffers—often above levels required by Basel III—have served to increase the resilience of African banks during the global financial crisis although this may have involved some costs for intermediation (Fuchs *et al*., 2012b).

The fact that financial sectors in LICs tend to be relatively smaller and simpler provides an advantage in that governments have more policy space to influence the future nature and scale of their financial system. Furthermore, the fact the financial sector is smaller may imply it is less powerful politically; thus, potentially this gives more autonomy to regulators and—more broadly governments—to shape the financial sector.

LICs thus have the advantage of being latecomers to financial development and can benefit from positive and negative lessons from experiences and research on other countries. On the other hand, the incompleteness of LIC financial systems means that important challenges remain on extending access (to all types of financial services) to those excluded, such as a high proportion of poor households, microenterprises and SMEs. More generally, it is difficult to fund working capital and investment in sectors such as agriculture and industry, especially for SMEs (and particularly at low spreads and longer maturities) crucial for growth and employment generation. The financing of infrastructure is a well-known problem in LICs, and the mobilization of sufficient long-term finance, as well as the most effective way to channel it to investment in that sector, is a key area of policy, where research, including clear understanding of market gaps—as well as effectiveness of policy interventions—could be very valuable.

Research on the desirable structure of the financial sector could include the following research themes and questions:

a) What functions are particularly important to meet in African LICs? What are the deficiencies and needs in these areas in LICs? For example, how can sustainable lending at relatively low spreads and sufficient maturities to SME be best encouraged? What are the main challenges for delivering that type of finance in LICs? What are the specific needs of particular sectors, e.g. agriculture, for innovation? These and related issues could be researched using a number of methods, including consultation with policymakers and practitioners, theoretical analysis, empirical analysis, such as cross country and time studies, as well as in-depth case studies. Surveys of private companies to determine unmet demand for financial services, and especially credit at reasonable cost, and maturity would be valuable.

b) What combination of public/private institutions/mechanisms may be desirable to best achieve the three objectives of growth, financial stability and equity? This would look—in general and in country settings—at the existence of market gaps and market failures in specific areas (e.g. long-term finance) in LICs, as well as potential government failures. Careful review of theoretical and empirical work needs to be combined with analysis of experiences to offer a balanced menu of policy options for most effective institutional arrangements in particular country contexts. What mechanisms (public guarantees, first losses assumed, for example by IFC) are desirable to encourage private financing? How can they be best structured to avoid excessive contingent public liabilities and for them to be effective? What experiences exist, which have worked well? How can they best be applied to LICs?

c) Since the 2007/2008 crisis, increased interest has emerged in expanding the role of national and regional development banks to provide counter-cyclical lending when private credit falls. Also, public banks can be valuable for incorporating environmental externalities, to give LICs the opportunity to "leap frog" by adopting low-carbon technologies. More broadly, public development banks can be a valuable mechanism for financing particular strategies of development. What are the incentives and institutional arrangements that are required to make such development banks effective and efficient in LICs? What lessons can be learned from successful banks in developed countries (e.g. the European Investment Bank, German KfW) and emerging economies (e.g. BNDES in Brazil, as well as Asian development banks)? Most research on the experiences with development banks in Africa dates from the 1980s and 1990s and evaluations report fairly negative experiences (Brownbridge *et al*., 1998). However, many development banks have been reformed over the past decade so that research implying re-evaluations of their effectiveness are necessary. Returning to the theoretical issues, what are the specific market gaps and failures which need addressing in specific LIC contexts, and how best can government failures be minimized? A hypothesis to be explored is that the effectiveness of development banks depends substantially on governance arrangements and political economy factors. Pressures on African governments to facilitate access to finance for the real economy may for example be particularly strong. What are pre-conditions, including political economy ones for such banks to be effective in LICs, in ways similar to how they have been in emerging and developed economies?

d) In the case of private banks, should a particular model, for example with respect to size, be encouraged? Many African countries banking systems have an oligopolistic structure where a small number of banks dominate the market and competition is limited. Is there a case that smaller more decentralized banks are better for reducing asymmetries of information? Are there more benefits from increased competition? Or are economies of scale an important factor for determining bank efficiency? Are potential costs of increased systemic risk of large banks so high that smaller, narrower banks may be preferable (Demigurc-Kunt and Huizinga, 2010)? What are the lessons, if any, for

African LICs from the debate in developed countries on the structure of banking, for example as reflected in the recent UK Vickers report? What should be the preferred model for international banks in African LICs? Should LIC regulators encourage/require international banks to act as subsidiaries, rather than branches, as the UN Stiglitz Report proposes, to facilitate the task of national regulation? In India and some other developing countries, branching regulations are in place. What have been the experiences with such regulations? Should international (and possibly all large banks) be required to have not just branches in large cities, but also in smaller cities?

e) To what extent is it best to concentrate in LICs on the development of banking, or should non-banking institutions (like stock markets and insurance markets) play also an increasingly important role? Both financial and human resources for developing and regulating non-bank institutions tend to be limited in African countries, so that efforts to develop such markets which are resource-demanding should be based on evidence-based policy advice. Should specialized lending institutions, like leasing or factoring companies, as well as low-end financial institutions, such as cooperatives, credit unions and microfinance be promoted, as suggested in Beck, Demigurc-Kunt and Singer (2011)? If the insights of imperfect and asymmetric information are central, such information tends to be local and specialized (Stiglitz, 2012); this may provide an important theoretical and practical justification for greater use of more low-end and more decentralized institutions. Would the latter, for example be particularly effective for the financing of SMEs, and more broadly for the so-called missing middle? What is the empirical evidence on this, especially in LICs? For many African households such low-end financial institutions constitute the only form of financial access. In Uganda, for instance only 21 percent of adults above the age of 15 have an account at a formal financial institution (Demirguc-Kunt and Klapper, 2012). Governments have hence promoted cooperatives, credit unions and microfinance. However, there is little systematic research comparing costs and benefits of promoting such low-end institutions as opposed to access to banking services. How can a more desirable mix be encouraged? What is the empirical evidence on which to base such decisions?

f) How can development of primary public debt markets be encouraged, to establish risk-free benchmark curves? Based on deepening of public bond market, how can the local corporate bond market best be developed, including for long-term institutional investors to buy? What are relevant lessons from the analysis of experiences in other parts of the world and of recent empirical work on growth impact of structures of different financial sectors?

g) What kind of institutional developments and financial innovations are valuable for promoting inclusive and more sustainable growth, without increasing systemic risk excessively? More specifically, what systems can improve access by the poor and by SMEs to sustained credit, without creating systemic risk for the financial system? Mobile

banking, which should be regulated proportionate to its risk, is an example for such an innovation. How can the poor not only have access to sufficient and sustainable credit, but be protected in times of crises, so that the poor are "not too small to be counted" during crises, whilst banks are rescued as considered too big to fail (BIS paper, 2012)? What are the complementarities between financial and other policies, e.g. for increasing productivity of SMEs?

3.2 THE CHALLENGES OF FINANCIAL REGULATION

A key lesson from recent crises has been the need for regulation to be both counter-cyclical and comprehensive to avoid the build-up of systemic risk (Griffith-Jones and Ocampo, 2009; Saurina and Repullo, 2011). Though there is agreement on these principles, there is far less consensus on how these should be implemented. A great deal of research and policy analysis is being carried out in the BIS, the IMF and the Financial Stability Board on these issues.

One of the key problems is that LICs are not represented at all or are heavily underrepresented in these bodies. Therefore, there is insufficient focus in their work on how relevant these issues are for LICs and how they should be implemented in them.

It may be useful to carry out research that would synthesize on-going discussions on these issues of counter-cyclicality and comprehensiveness, as well as other key issues that LIC regulators and policymakers define as a priority for them. Over the past decade, there has been rapid credit growth in a number of African countries including Angola, Democratic Republic of Congo, Equatorial Guinea, Ghana, Guinea-Bissau, Liberia, Malawi, Nigeria, São Tomé and Príncipe, Sierra Leone, Swaziland, Tanzania, and Zambia (Iossifov and Khamis, 2009). Whether a manifestation of a credit boom or driven by fundamentals, rapid credit growth can give rise to systemic financial and macroeconomic risks, making the design and implementation of appropriate macro-prudential regulation and supervision a policy priority in Africa. For example, the Final Report of *Making Finance Work for Africa*, in collaboration with the Association of African Central banks (AACB) and Bank of Uganda (2011) defined as most relevant and urgent for African LICs—within Basel III—the incorporation of macro prudential supervision. Relevant research in this field would be therefore seen to be a priority. Similarly, the concept of proportionality in regulation implies that regulatory standards should be set in a way proportional to the importance of the risks. (GPFI/CGAP, 2011) and Basle Committee, 2010). This requires further research for LICs.

In the case of macro-prudential regulation, an important research issue is how can it be complementary to monetary policy in LICs? Macroeconomic volatility, for instance, remains a problem, partly because many African countries exports are concentrated in a few commodities, which makes their economies vulnerable to the large price shocks characteristic of commodities.

Furthermore, practical issues on how best to implement macro-prudential policy would require research. These could include:

a) What, in the LIC context, is the best choice of regulatory instruments through which counter-cyclical regulation can best be implemented both for solvency and liquidity?

What are the best indicators to determine in LICs when capital requirements or provisions need to be increased in boom times, or allowed to be drawn down in bad times? How should the variables and methodologies suggested internationally for counter-cyclical regulation be adapted to realities in LICs, as regards data limitations, as well as broader context of the smaller financial sector and existing financial regulation (Bank of Uganda, 2012)?

b) Should counter-cyclical regulation of banks be done in LICs mainly at an aggregate level and/or in specific sectors, for example where lending is increasing fastest? How relevant is the emerging international experience in this field (Ren, 2011) for LICs? Should such measures be implemented through *ex ante* rules or have some flexibility?

c) Focusing on the issue of comprehensiveness, how relevant are the international analyses of comprehensive regulation for African LICs and how any international conclusions should be modified for the LIC context? This requires taking into account the different nature of the financial system in LICs, where for example many financial transactions go through informal channels, or financial services are provided by non-banking institutions like retail shops or mobile service providers. The mobile payment service M-Pesa, developed in Kenya, is a case in point. M-Pesa was launched to target mobile subscribers who were un-banked and now has over 7 million customers, both banked and un-banked. Light regulation in the testing phase of the financial product, on the principle of proportionate supervision, contributed to M-Pesa's rapid growth. However, at a later stage of product development and at a higher level of outreach, regulation may need to become significantly more stringent for M-Pesa's success to be sustainable. Yet comprehensive regulation of M-Pesa and other financial innovations may call for closer coordination between regulators of such institutions (e.g. telecommunications regulators in mobile banking) and banking regulators. Therefore, the challenge of comprehensive regulation has a very different institutional character in LICs. Does this mean that underlying principles should also be different, or is the criteria of avoiding systemic risk and concentration of risk common to any financial system?

d) Also in relation to aims of financial regulation, in LICs these include more explicitly the purpose of inclusive growth. Can regulations go beyond stability and be designed more explicitly for growth? How can moral hazard best be avoided? Could lending support industrial policies, regional mandates, to ensure poor regions have more access to credit? What is the experience on establishing minimums and maximums of lending in certain categories, e.g. SMEs? Are experiences like the US Community Reinvestment Act or the Small Business Administration successful and relevant to LICs? Are their similar successful experiences in LICs?

Another issue highlighted by the *Making Finance Work for Africa* report, *op cit* as high priority are regional/cross-border issues. This refers not only to regulation of traditional international banks, but also to the rapidly emerging pan-African banks. As Fuchs, *et al* (2012b) point out, recent reforms of the international supervisory architecture concentrated on creating

colleges of supervisors for all internationally operating banks. Representation of African supervisors (especially LICs) is very limited; this is a source of concern as an international bank may have a small part of its portfolio in an African country, but implies a very large share of their market for a particular LIC country. The role of the LIC supervisor in these colleges becomes too small, if any at all, with potentially serious consequences for financial stability and growth impact in the LIC country. Research could be valuable, both on the institutional and technical aspects, but also on the political economy of how practically to enhance the "voice" of LIC supervisors in cross-border supervisory processes that have strong impacts on their economy, to overcome asymmetries of power that can lead to economically inefficient outcomes for LICs.

A key source of macro-economic volatility, as well as of financial systemic risk, is generated by certain types of capital flows. As a result, there has been growing recognition, in IMF and BIS, as well as in the academic literature (for example Stiglitz and Ocampo, 2008; Korinek, 2011; Gallagher, Griffith-Jones and Ocampo, 2012) on the need for management of the capital account. One of the newest research and policy challenges is how to most effectively combine regulation of capital flows and national counter-cyclical regulation. Again discussion in LICs has been more limited. Are capital account management measures needed also in LICs and under what circumstances? In best practice, when are capital account regulations more effective, and when are domestic prudential regulations, which focus on currency mismatches? How best can they complement each other?

The type of issues to be examined on capital account management for LICs would relate to issues of: a) timing, relating to how soon after a surge of capital flows starts occurring should measures to discourage more short- term flows be used? b) should they be temporary or part of a permanent system that can be suspended? c) if and when should these regulations be price or quantity based? d) How can avoidance be prevented?

Our analysis above has focused more on discouraging excessive short-term capital flows when they threaten to cause macro-economic over-heating, overvalued exchange rates and increase financial sector systemic risk. However, there is also the important issue of attracting long-term capital flows, especially where it can provide technology transfer and access to new markets. This is a topic that now has new dimensions, such as the increased role of Chinese and other Southern investors. Research and research synthesis is needed on the positive impact and potential risks to the financial sector of these new country sources and modalities of investment.

4. CONCLUSION

While the 2007/8 crisis originated in, and strongly hit, developed economies, there is no reason for complacency in regulating African financial sectors. Fairly rapid credit growth in the late 2000s in the context of limited regulatory and supervisory capacity, especially in some countries, suggests that the time is now to draw appropriate lessons from the North Atlantic crises for African countries. There is also no reason to believe that if major private financial crises have hit all other continents, Africa would be an exception, unless it proceeds very

cautiously with financial liberalization and financial development, as well as accompanies it with strong and effective regulation. Furthermore, the fact that African LIC systems are still relatively small in relation to the size of their economies allows more space for African policymakers and regulators to try to shape their financial systems so they serve well the needs of the real economy, by helping support inclusive and sustainable growth (for example by supporting much needed lending to SMEs), as well as desirable structural change.

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